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GAO

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General Accounting Office
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Health, Education and Human Services Division

B-257207

August 12, 1994

The Honorable John E. Porter
Ranking Minority Member
Subcommittee on Labor, Health and Human
Services, and Education
Committee on Appropriations
U.S. House of Representatives

Dear Mr. Porter:

This letter provides, at your request, an update of our 1990 report on your proposal to create a system of Individual Social Security Retirement Accounts (ISSRAs), Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves (GAO/HRD-91-22, Dec. 12, 1990). Enclosures I through III summarize our updated calculations based on our 1990 work and the most recent assumptions and projections for the Social Security program provided by the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (OASDI).

Under your proposal, a portion of the accumulating reserves of the Social Security Trust Funds would be returned to workers and placed in ISSRAs, where they would be invested in the private sector. This would provide workers a private source of retirement income in addition to Social Security benefits. In our 1990 report, we analyzed your proposal and its implications for the federal deficit, national savings, and the retirement income of individuals. The analysis provided here relates only to the last of these topics, and, in general, our findings are consistent with those in our 1990 report. At that time we found that ISSRAs could be integrated with the progressive benefit structure of Social Security and, given favorable market conditions, could improve retirement incomes (see enclosure I).

The version of your ISSRA proposal that we analyzed in 1990 differs in several ways, however, from the proposal that you have sponsored in H.R. 306. Also, the 1994 OASDI Trustees' projections of the program's financial status differ from those in 1990. Because of this, we performed additional computations that incorporate key features of the current Trustees' projections (see enclosure II) and

H.R. 306 (see enclosure III). The following discussion elaborates on the source of the differences and some of the implications arising from them.

KEY DIFFERENCES BETWEEN H.R. 306 AND THE 1990 PROPOSAL

Three key differences arise in comparing the ISSRA proposal in H.R. 306 with the 1990 proposal. These relate to (1) the basis and size of the payroll tax diversion to ISSRAs, (2) the duration of the ISSRA program, and (3) the applicability of a Social Security benefit adjustment.

ISSRA Payroll Tax Diversion and Program Duration

The 1990 version of the ISSRA proposal involved a temporary diversion of payroll tax revenues to ISSRAs along with a Social Security benefit reduction. The payroll tax diversion was set at 2 percent of taxable payroll (which can be considered as 1 percent each for employer/employee) on the basis of 1990 OASDI projections. These projections showed an excess of the program's income rate over the cost rate of about 2 percent of payroll annually from 1990 to 2015. This period defined the duration of the ISSRA program, during which diversions to individual accounts would take place. When the projected OASI cost rate would rise to equal the income rate, the ISSRA program would effectively end except for the accumulation of interest in the accounts and their subsequent payout to retirees. This is what is meant by a "temporary" scheme.

H.R. 306 preserves the 2 percent payroll tax diversion to ISSRAs. However, the amount of "excess" payroll taxes is somewhat different in the 1994 Social Security projections compared with those in 1990. The 1994 projections estimate that the excess of the income rate over the cost rate is only about 1 percent of taxable payroll annually from 1995 to 2015. This suggests that a diversion of 2 percent to ISSRAs would deplete projected Social Security trust fund contingency reserves.

Also, H.R. 306 does not provide for a phase-out of the ISSRA diversion when the excess payroll tax under the current financing projections phases out (that is, when the cost rate exceeds the income rate). In this sense, H.R. 306 proposes a "permanent" ISSRA scheme. Absent other changes, this means that the need to adjust payroll taxes will become even greater than under the existing Social Security program projections. Continuation of the ISSRA program would require future payroll tax increases, or benefit reductions, to maintain Social Security on a pay-as-you-go (PAYG) financing basis. While adjustments to maintain PAYG financing in the future are expected on the basis of current projections, the necessary changes will be larger and have to occur sooner under H.R. 306.

Adjustment of Social Security Benefits

H.R. 306 also differs from the 1990 proposal because it does not provide for a reduction in each individual's Social Security benefit to account for the diversion of payroll tax revenues to the ISSRAs. In our original analysis, the legislated payroll tax was effectively considered to be the "price" of receiving a future Social Security benefit. This was considered a given even though the payroll tax rate is set higher than necessary to meet the current costs of the system. Under this perspective, if workers divert a portion of their payroll taxes to an ISSRA, they should receive a benefit reduction. Our 1990 report was largely an effort to devise an adjustment to the benefit formula to account for the diversion of payroll taxes to ISSRAs while preserving its progressive structure. Our estimates showed that retirees could receive a higher overall retirement benefit if the return on their ISSRA exceeded the implicit "return" to Social Security for their retirement cohort.[1]

Since H.R. 306 does not provide for a benefit reduction, workers will generally receive a higher total retirement income (Social Security plus ISSRA) under H.R. 306. However, as suggested in the discussion above, the government would be required to make adjustments to finance the promised level of Social Security benefits in the future. The ISSRA program embodied in H.R. 306 achieves a reallocation of the current excess payroll tax into private accounts that would prevent the use of Social Security revenues to finance other government programs. However, once the Social Security program would no longer generate these excess payroll taxes, the ISSRA program would effectively become a mandatory defined contribution supplement to Social Security. Alternative measures would be necessary to finance the promised level of Social Security benefits.

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[1]An estimate of the implicit return to Social Security was used to compute the benefit reduction.

Updated Estimates for the ISSRA Proposal

Enclosures I through III present our updated estimates for the ISSRA proposal. Enclosure I essentially updates the tables in our 1990 report using the 1994 OASDI Board of Trustees assumptions. Table I.1 shows the replacement rates and implicit rate of return for hypothetical workers born in 1960. The cases shown in the tables represent workers with continuous work histories (that is, "steady earners"). The average case represents a worker who annually earns the average of all workers covered under Social Security. The maximum case represents a worker who is credited with the maximum earnings subject to payroll taxes annually. The low case represents a worker who annually earns 45 percent of average earnings.

Table I.2 shows the estimated benefit for each case and is intended to demonstrate the benefit adjustment that we derived. When the worker earns a rate of return on the ISSRA that equals the implicit rate of return to Social Security earned by that worker's retirement cohort, the benefit reduction just offsets the ISSRA. This means that the benefit adjustment reduces benefits but preserves the progressive structure of the benefit formula.

Table I.3 illustrates estimates of total retirement income under different rate-of-return scenarios for hypothetical workers born in 1960. Under our moderate interest rate assumption, the ISSRA earns a real return of 3 percent, which is 1 percent above the assumed 2 percent implicit return to Social Security. This results in a new monthly retirement income[2] (Social Security plus ISSRA) that is $31.29 higher than the current Social Security benefit of $1125.79. This compares with an increase of $29.23 in our 1990 analysis. Table I.4 contains estimates for the average worker by birth cohort. In part because of the assumed temporary nature of the earlier ISSRA proposal, no cohort contributes to the ISSRA account for more than 21 years nor receives an increase in income greater than about 5 percent of the current law Social Security benefit.

Enclosure II shows our estimates for the scenario in which the temporary payroll tax diversion is only 1 percent. This scenario is based on our 1990 analysis and reflects the change in the financial status of Social Security shown in the 1994 Trustees' projections.

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[2]All benefit amounts quoted are monthly.

Enclosure III shows our estimates for a scenario that closely resembles the ISSRA proposal embodied in H.R. 306. This includes a 2-percentage point diversion of payroll taxes without any reduction in Social Security benefits to account for the payroll tax diversion to the ISSRA. Also, the ISSRA proposal simulated here is permanent. Cohorts born after the mid-1970s would contribute to the ISSRA throughout their careers (47 years, under our assumptions). The results show that a hypothetical average worker born in 1960 who earns a real return of 3 percent on the ISSRA would have a total monthly retirement income that is $180.60 higher than could be obtained from Social Security alone.

RELATED TECHNICAL ISSUES

In updating our earlier analysis of the ISSRA proposal, we have identified some additional technical issues that may affect any evaluation of H.R. 306.

Annuities

Our 1990 report calculated benefits based on a premise that the ISSRA accumulations could be annuitized as a Social Security benefit. We did this largely to simplify the analysis and compare the potential total benefit under the ISSRA program with that under Social Security. However, if ISSRA accounts are not annuitized on this basis and instead are annuitized in the private sector, they will be subject to private annuity prices, which will include loading charges. In this case, ISSRA benefits may be smaller than those shown in our calculations.

Treatment of ISSRAs as Individual Retirement Accounts (IRAs)

In our 1990 analysis, we treated the ISSRAs as if they would be used strictly as a retirement benefit. The implicit assumption was that the accounts would be converted to an annuity at the time the Social Security benefit was received and that no withdrawal would be permitted. This approach was adopted for analytical purposes so that benefit comparisons between the ISSRA program and Social Security could be made on a consistent basis. H.R. 306 introduces provisions that make the treatment of ISSRAs similar to IRAs. This treatment introduces several complications in the analysis of ISSRAs.

First, under the IRA-like treatment, withdrawals could be made from ISSRAs prior to the age at which Social Security benefits are received. Generally, ISSRAs could be received at age 59½ and later, but the funds in the account could be withdrawn even earlier with penalty. This would make for a different set of outcomes than those that appear in our calculations. If individuals would decide to take their ISSRA as a lump sum, the effect on retirement income is difficult to estimate. In this case, the ISSRA might not contribute to retirement income at all. If the ISSRA is annuitized prior to age of Social Security benefit receipt, the benefit may be lower than we show in our calculations. This may occur in part because contributions are not made to the ISSRA between the time of receipt and the time of Social Security benefit receipt (for example, between age 59½ and 65).

A second complication under the IRA treatment relates to the tax treatment of benefits. Social Security benefits are not subject to income taxation for most individuals. Under H.R. 306, the IRA treatment of ISSRAs means that income from the ISSRA is subject to income tax upon retirement. But this feature could also result in lower net income for individuals in retirement than is reflected in our calculations. This also means that the ISSRA program would generate income tax revenues. The revenue effect is enhanced because individuals can withdraw from the ISSRA account at age 59½ and even earlier with penalty.

<u>ISSRAs and Survivor Benefits</u>

Our earlier analysis confined the ISSRA program to apply only to the retirement benefit portion of Social Security. We did this to avoid complications concerning the other benefits provided by Social Security, particularly dependent and survivor benefits. In the 1990 analysis, we assumed that benefits other than those for retirement would continue to be financed on a PAYG basis. The 2-percentage point diversion was taken from the retirement portion of Social Security. One complication arising from ISSRAs concerns the possible inheritance of the account upon an individual's death. A social insurance perspective suggests that the ISSRA revert to Social Security to pay retired worker benefits, since survivor benefits are already financed with a portion of the payroll tax. If the ISSRA does not revert to Social Security, this implies that it provides a supplement to Social Security survivor benefits. This raises the issue of whether any additional adjustment to retired worker benefits should occur to account for the additional supplementary survivor benefit.

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The work done to respond to your request was performed under the supervision of Donald C. Snyder, Assistant Director. Kenneth C. Stockbridge, Senior Evaluator, and Kenneth J. Bombara, Senior Economist, conducted the study.

As agreed with your office, unless you announce its contents earlier, we plan no further distribution of this letter for 30 days. At that time, it will be made available upon request. If you or your staff have any questions concerning this letter, please contact either Mr. Snyder or me at (202) 512-7215.

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Director, Income Security Issues

Enclosures - 3

Table I.1: Replacement Rates and Implicit Rates of Return, by Income Level (Workers Born in 1960, Single-Earner Families)

	Income level		
	Low	**Average**	**Maximum**
Replacement rate	55.83%	41.63%	27.68%
Implicit rate of return (inflation-adjusted)	3.93%	2.80%	1.10%

Table I.2: Proposal's Impact on Retiree Incomes When ISSRAs Earn Social Security Age-Group Rate of Return (by Income Level for Workers Born in 1960)

Temporary 2-percentage point diversion with benefit adjustment

	Income level		
Monthly dollar results (1994 dollars)	**Low**	**Average**	**Maximum**
Current law benefit	$679.43	$1,125.79	$1,785.33
- Benefit reduction	45.65	101.44	243.91
+ ISSRA annuity	45.65	101.44	243.91
New retirement income	**$679.43**	**$1,125.79**	**$1,785.33**
Percentage results			
Benefit reduction	6.72%	9.01%	13.66%
Change in income	0.00%	0.00%	0.00%
ISSRA as percent of income	6.72%	9.01%	13.66%

Note: Assumes inflation-adjusted age group rate of 2.0 percent under Social Security.

Table I.3: ISSRA Proposal's Impact on Retiree Incomes By Market Interest Rate Assumption[a] (Average Steady Earners Born in 1960)

Temporary 2-percentage point diversion with benefit adjustment

	Interest rate assumption (inflation-adjusted)		
Monthly dollar results[b] (1994 dollars)	**Pessimistic (1%)**	**Moderate (3%)**	**Optimistic (7%)**
Current law benefit	$1,125.79	$1,125.79	$1,125.79
- Benefit reduction	101.44	101.44	101.44
+ ISSRA annuity	88.56	132.73	302.44
New retirement income	**$1,112.91**	**$1,157.08**	**$1,326.79**
Percentage results			
Benefit reduction	9.01%	9.01%	9.01%
Change in income	-1.14%	2.78%	17.85%
ISSRA as percent of income	7.96%	11.47%	22.79%

[a] Assumes inflation-adjusted age group rate of 2.0 percent under Social Security.

[b] Numbers may not add due to rounding.

Table I.4: ISSRA Proposal's Impact on Retiree Incomes Using Moderate Market Rate Assumption (by Age Group for Average Steady Earners)

Temporary 2-percentage point diversion with benefit adjustment	Workers born in					
Age group attributes	1940	1950	1960	1970	1980	1990
Number of years with ISSRA deposits	11	21	21	21	16	6
Inflation-adjusted age group return rate	2.6%	2.3%	2.0%	2.0%	2.0%	2.0%
Monthly dollar results[a] (1994 dollars)						
Current law benefit	$926.35	$1,015.88	$1,125.79	$1,238.84	$1,363.33	$1,500.25
- Benefit reduction	38.08	83.78	101.44	123.66	111.59	48.40
+ ISSRA annuity	39.56	93.25	132.73	182.96	179.98	82.67
New retirement income	$927.84	$1,025.34	$1,157.08	$1,298.14	$1,431.72	$1,534.52
Percentage results						
Benefit reduction	4.11%	8.25%	9.01%	9.98%	8.19%	3.23%
Change in income	0.16%	0.93%	2.78%	4.79%	5.02%	2.28%
ISSRA as percent of income	4.26%	9.09%	11.47%	14.09%	12.57%	5.39%

[a] Numbers may not add due to rounding.

Table II.1: ISSRA Proposal's Impact on Retiree Incomes by Market Interest Rate Assumption[a] (Average Steady Earners Born in 1960)

Temporary 1 percentage point diversion with benefit adjustment

	Interest rate assumption (inflation-adjusted)		
Monthly dollar results[a] (1994 dollars)	**Pessimistic (1%)**	**Moderate (3%)**	**Optimistic (7%)**
Current law benefit	$1,125.79	$1,125.79	$1,125.79
- Benefit reduction	50.72	50.72	50.72
+ ISSRA annuity	44.28	66.36	151.22
New retirement income	**$1,119.35**	**$1,141.43**	**$1,226.29**
Percentage results			
Benefit reduction	4.51%	4.51%	4.51%
Change in income	-0.57%	1.39%	8.93%
ISSRA as percent of income	3.96%	5.81%	12.33%

[a] Assumes inflation-adjusted age group rate of 2.0 percent under Social Security.

[b] Numbers may not add due to rounding.

Table II.2: ISSRA Proposal's Impact on Retiree Incomes Using Moderate Market Rate Assumption (by Age Group for Average Steady Earners)

Temporary 1-percentage point diversion with benefit adjustment

	Workers born in					
Age group attributes	1940	1950	1960	1970	1980	1990
Number of years with ISSRA deposits	11	21	21	21	16	6
Inflation-adjusted age group return rate	2.6%	2.3%	2.0%	2.0%	2.0%	2.0%
Monthly dollar results[a] (1994 dollars)						
Current law benefit	$926.35	$1,015.88	$1,125.79	$1,238.84	$1,363.33	$1,500.25
- Benefit reduction	19.04	41.89	50.72	61.83	55.79	24.20
+ ISSRA annuity	19.78	46.62	66.36	91.48	89.99	41.33
New retirement income	$927.09	$1,020.61	$1,141.43	$1,268.49	$1,397.52	$1,517.39
Percentage results						
Benefit reduction	2.06%	4.12%	4.51%	4.99%	4.09%	1.61%
Change in income	0.08%	0.47%	1.39%	2.39%	2.51%	1.14%
ISSRA as percent of income	2.13%	4.57%	5.81%	7.21%	6.44%	2.72%

[a] Numbers may not add due to rounding.

Table III.1: ISSRA Proposal's Impact on Retiree Incomes by Market Interest Rate Assumption[a] (Average Steady Earners Born in 1960)

Permanent 2-percentage point diversion without benefit adjustment

	Interest rate assumption (inflation-adjusted)		
Monthly dollar results[a] (1994 dollars)	Pessimistic (1%)	Moderate (3%)	Optimistic (7%)
Current law benefit	$1,125.79	$1,125.79	$1,125.79
ISSRA annuity	132.03	180.60	360.77
New retirement income	$1,257.82	$1,306.39	$1,486.56
Percentage results			
Change in income	11.73%	16.04%	32.05%
ISSRA as percent of income	10.50%	13.82%	24.27%

[a] Numbers may not add due to rounding.

Table III.2: ISSRA Proposal's Impact on Retiree Incomes Using Moderate Market Rate Assumption (by Age Group for Average Steady Earners)

Permanent 2-percentage point diversion without benefit adjustment

	Workers born in					
Age group attributes	**1940**	**1950**	**1960**	**1970**	**1980**	**1990**
Number of years with ISSRA deposits	11	21	32	42	47	47
Monthly dollar results[a] (1994 dollars)						
Current law benefit	$926.35	$1,015.88	$1,125.79	$1,238.84	$1,363.33	$1,500.25
ISSRA annuity	39.56	93.25	180.60	296.27	388.26	427.08
New retirement income	$965.91	$1,109.13	$1,306.39	$1,535.11	$1,751.59	$1,927.34
Percentage results						
Change in income	4.27%	9.18%	16.04%	23.92%	28.48%	28.47%
ISSRA as percent of income	4.10%	8.41%	13.82%	19.30%	22.17%	22.16%

[a] Numbers may not add due to rounding.

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